Chapter 9

CONSUMED INCOME TAX

A tax on consumed income, one of the four options considered by the Treasury Department in its study of fundamental tax reform, is a frequently mentioned alternative to the income tax. The base of a comprehensive personal tax on consumption, or consumed income, differs from that of a comprehensive income tax only in that a deduction is allowed for net saving. This effectively excludes capital income from the tax base because deferring the tax on saving until withdrawal is, on average and in present value terms, equivalent to exempting the return to saving from taxation.

Apart from the deduction for net saving, the bases of the two types of taxes are identical. They are both direct personal taxes which can be structured to reflect the individual circumstances of taxpayers. Thus, like the income tax, a consumed income tax can contain personal exemptions, a zero-bracket amount, itemized deductions, and flat or graduated rates. Personalization of this type is not possible under a transaction-based sales tax on consumption, such as a value-added tax or a national retail sales tax (discussed in chapter 10).

A comprehensive consumed income tax and a comprehensive income tax also share the advantages obtained from moving from the current, narrow base to a broad, uniform tax base. (These advantages are discussed in chapter 5.) Many of the issues covered in the discussion of the base of a modified income tax would also arise under a tax on consumed income. For example, except for contributions to retirement plans, most fringe benefits provided by employers represent a form of consumption; therefore, they should be subject to a tax on consumed income as well as on all income. Similarly, expenditures such as for moving expenses and medical care might not be viewed as taxable consumption, just as they may be viewed as reducing ability to pay income taxes. Other expenditures that qualify as itemized deductions under the current income tax, such as state and local taxes and charitable contributions, could either be granted or denied preferential treatment under the consumed income tax. Because these issues are, for the most part, no different under a consumed income tax and an income tax, they are not discussed further in this chapter.

This chapter describes the main features of a consumed income tax, and then discusses its advantages and disadvantages. It is important to specify clearly whether a consumed income tax is being compared to the current income tax or to a broad-base income tax. Since a consumed income tax and a comprehensive income tax share many of the same advantages over current law, the more important comparision for judging the desirability of a consumed income tax is with a broad-base income tax.

I. Consumed Income Tax Base, Rates, and Administration

A tax on consumed income would not be administered by asking a taxpayer to add together all consumption expenditures during the year; that would clearly be an impossible task. Rather, the taxpayer would report total income and be allowed a deduction for net saving. Conversely, dissaving would be subject to tax. All saving and dissaving would have to occur through "qualified accounts" held with financial institutions so that annual saving and dissaving could be reliably reported and measured.

A. The Tax Base.

The principle of taxing consumption determines the treatment of loans under a consumed income tax. Since repayment of debt is equivalent to saving, a deduction would be granted for such repayment and for payments of interest; similarly, the proceeds of borrowing would be included in taxable consumption. If net loan proceeds were not included in the tax base, taxpayers could "game" the tax system simply by borrowing funds, depositing them in a qualified account, and taking a deduction for the increase in their "saving". Purchasing assets with borrowed funds does not add to net saving, and therefore would not qualify for a deduction under a consumed income tax. Although the present value of the taxes might not be affected, since the taxpayer could not deduct the repayments and interest on the loan, omitting borrowing from the base would enable the taxpayer to postpone the liability. This would disrupt the timing of government receipts and would seem unfair. More extreme tax avoidance would occur if borrowing were not in the base but deductions were allowed for loan repayments, or even just for interest payments. Under these circumstances taxpayers could actually reduce their future as well as present tax liability by borrowing.

An exception to the rule on borrowing could be made to exclude the proceeds of home mortgages from the base of a consumed income tax, provided that no deductions were allowed for subsequent repayment of principal and interest. This treatment would avoid a huge consumption tax liability at the time of home purchase and would effectively spread out tax payments over the life of the loan (since deductions for loan repayment and interest are denied), without the complexity of actual averaging. Similarly, tax on withdrawels from a qualified account used for a down payment on a home could be spread out, too. Special treatment for owner-occupied housing might be acceptable because, under certain circumstances, it would not alter the present value of taxes, and because the possibilities for "gaming" would be limited.

The tax treatment of business assets would also be based on the principle of taxing consumption. Accordingly, the purchase of business assets would be deducted immediately; that is, investment is expensed under a consumed income tax. The returns to the asset and the amount received upon sale would be included in the tax base, unless reinvested. Similarly, the purchase of corporate stock or other financial assets is deductible; dividends and interest received, as well as the receipts from selling the stock or bond, are included in the tax base unless they are saved.

Under a consumed income tax, there is even less theoretical justification for a corporate income tax than under a comprehensive income tax. The rationale for eliminating the corporate income tax is easily seen by considering the uses to which net corporate income can be put. Earnings that are retained should not be taxed because they are a form of saving, and the consumed income tax explicitly excludes saving from the tax base. Corporations would not pay tax on income distributed to shareholders, because dividends would be taxable to shareholders, unless they saved them. At most, a corporate income tax might be retained for three reasons: (1) to prevent foreign investors in the United States from automatically benefitting from the elimination of the corporate income tax, (2) to assess an additional tax on extraordinary returns to investment in the corporate sector, or (3) to tax indirectly corporate expenditures which represent consumption on the part of employees by denying corporations deductions for such expenditures.

There is general agreement that gifts and inheritances should be included in the taxable consumption of the recipient, unless saved. Some advocates of a tax on consumed income believe that gifts and bequests also represent consumption of the donor, and thus should be included in the tax base of the donor, as well as in the base of the recipient. This would make the base of the consumed income tax lifetime income. However, other advocates of a consumed income tax point out that this would amount to double taxation of the gift or bequest, and believe quite strongly that gifts and bequests should be taxed only to the recipient and not to the donor. The distributional implications of this issue are enormous. If bequests and gifts were excluded from the consumed income tax base of the donor, higher rates would be required to approximate the existing distribution of tax burdens by income class. Moreover, the "wealthy miser" would almost completely escape tax under such a tax on consumed income, and large fortunes could be passed on between generations tax-free.

Thus, under a comprehensive consumed income tax, the tax base would include all forms of current monetary and in-kind income, the current consumption value of all fringe benefits supplied by employers, the proceeds of sales of capital assets and the returns to direct investment that are not reinvested, withdrawals in excess of deposits in saving accounts, the proceeds of all borrowing in excess of loan repayments, and gifts and inheritances received. Accrued interest, earnings from ownership of corporate shares, increases in the value of pension and life insurance reserves, and other increases in the value of asset holdings would not be subject to tax until paid out, borrowed, or otherwise withdrawn for consumption.

This tax on consumed income then amounts to a tax on the sum of gifts, inheritances, and labor income received. For the economy as a whole and for most taxpayers, who receive only an insignificant amount of gifts and inheritances, a consumed income tax would, in fact, be virtually equivalent to a tax only on wages. Capital income would in effect be exempt. Although individuals would have to pay tax on capital income when it was used for consumption, the deduction of saving (out of wages) and the tax exemption of interest income results in a present value of the tax liability which, under certain circumstances, is the same as if the individual had been taxed only on total wages when paid.

B. Tax Rates

Because the household sector is a net lender in the economy, the base of a consumed income tax would be smaller than the base of an income tax with identical treatment of items other than capital income. Thus, to raise an equal amount of revenue as an income tax, a consumed income tax would have to have higher rates. The tax exemption of capital income must be weighed against higher marginal tax rates on labor income. The percentage difference in marginal tax rates between a consumed income tax and a broad-based income tax would depend on the difference in the tax base. The tax rates under a consumed income tax might still be lower than the rates on the narrow base of the current income tax.

C. Administration

In order to administer a consumed income tax and to minimize noncompliance, almost all financial transactions would have to be conducted through one or more IRA-type qualified accounts held through banks, brokerages, or other financial institutions to insure reliable information reporting. A useful way to think of qualified accounts under a tax on consumed income is to imagine extension of the present rules for individual retirement accounts (IRAs) and Keogh plans to cover all forms and amounts of saving and dissaving (including loans). Any amounts put into such accounts (including loan repayments of principal and interest) would be deductible. Investment income earned on the accounts would be currently tax exempt unless withdrawn, but any withdrawal from the accounts (including the proceeds of loans) would be taxable.

Requiring virtually all financial transactions to be recorded through a qualified account is necessary to prevent abuses of the tax system. In some cases, the present value of the tax liability of transactions conducted outside of qualified accounts might be the same as transactions through qualified accounts, but the taxpayer would be able to time the tax payments to his or her advantage. Excluding the proceeds of borrowing from the tax base (which is equivalent to borrowing outside of qualified accounts) provides an example of this. In other instances, avoiding qualified accounts could actually reduce the present value of the tax liability. This could occur if the taxpayer expects unusually high returns on an investment. By not making an investment through a qualified account, and not getting a deduction for it, the taxpayer "prepays" the tax. But the value of the tax on the actual consumption from the high returns would have been greater than the prepayment amount. Allowing taxpayers to choose whether to use qualified accounts would provide only ex ante equity in taxation, whereas requiring qualified account treatment for all transactions provides ex post equity.

The unit of taxation under a consumed income tax would probably be the family, rather than the present tax unit. The problems under an income tax caused by transfers of income to family members with low marginal rates would be magnified under a consumed income tax. Consumption cannot be as clearly attributed to individual family members as income can. Distinctions between a "gift" and "shared consumption" would be meaningless within most families. Furthermore, the family is the more appropriate unit for taxing consumption, since in general all family members (at least within the same household) share in a common standard of living.

II. Advantages of a Consumed Income Tax

One of the major advantages that a comprehensive consumed income tax would have over the present income tax would be a uniform tax base, which would eliminate many of the economic distortions and inequities of the present system. Of course, a comprehensive income tax would share this advantage over current law. Relative to a broad-base income tax, a comprehensive consumed income tax would still have several advantages in terms of administration, economic effects, and equity.

A. Administrative Advantages

The main administrative advantages of a tax on consumed income are that it avoids most problems of measuring income from business and capital, it does not require complicated indexing adjustments to make it inflation-proof, and it provides a simple solution to the current problems of tax shelters and tax arbitrage.

1. Income measurement issues. The measurement of income from business and capital is inherently difficult. Many of the most complicated provisions of the current income tax can be traced to problems of income measurement. A major advantage of a tax on consumed income would be that it avoids most of these problems.

Business income measurement. A number of the complexities in measuring business income stem from issues of timing. For example, under current law taxpayers are allowed to choose whether to employ cash or accrual accounting. Under either accounting convention, there are important questions of interpretation. When, for example, should a cash-basis taxpayer record expenses incurred during one year for the purpose of earning income in a later year? When should an accrual basis taxpayer reflect income from projects that extend beyond one year? Taxpayers employing different accounting methods -- including affiliated or commonly owned taxpayers -- can engage in transactions that produce recognition of expenses (by the accrual basis taxpayer) but postponement of recognition of receipt (by the cash basis taxpayer), thereby reducing their aggregate tax liability. Under most proposals, a consumed income tax would be based on cash flow; the taxpayer has or has not paid or received cash or its equivalent. None of the problems described above would exist under a consumed income tax of this type.

Problems of depreciation accounting, depletion allowances, amortization, and accounting for inventories for tax purposes also would not arise under a consumed income tax. The cost of depreciable assets would simply be currently deducted (expensed) in the year of acquisition under the cash flow tax. Similarly, expenditures on goods placed in inventory would be automatically expensed. Various other types of cash expenditures are expensed, rather than capitalized and amortized over their useful life. In the case of natural resources, all costs of acquisition, exploration, and development would be expensed, rather than recognized over the lifetime of the resulting asset through cost depletion; the possibility of percentage depletion should never arise. By comparison, under the income tax it is necessary to determine the useful life of assets and the pattern of depreciation to employ for tax purposes. Special and arbitrary rules are required under current law for property such as motion pictures, sound recordings, and trademarks.

For certain purposes the characterization of an income flow can affect tax treatment under the income tax; for example, the distinction between dividends and interest is often important. Under an ideal tax on consumed income all such distinctions would be irrelevant. Perhaps more important, the distinction between income and return of capital would also be meaningless under a tax on consumed income since cash received would be taxable unless reinvested. Similarly, payment of cash would always produce deductions, whether the payments were for expenses or for repayment of capital.

Capital gains would not be subject to tax under an ideal tax on consumed income. Rather, the taxpayer would be allowed a deduction for the full value of expenditures on capital assets. The entire proceeds of asset sales would be included in taxable consumption, unless reinvested. This treatment would have several administrative advantages. First, there would be no need to know the original basis (usually the cost) of capital assets, since basis would be irrelevant in calculating the consumed income tax; this would greatly simplify both taxpayer compliance and tax administration. Second, since capital gains would receive no special treatment, there would be no incentives to characterize income as capital gain. This would eliminate the complex distinctions between capital gains and ordinary income in current law, as well as the associated tax shelters.

Averaging. Current law includes some fairly complicated provisions for income averaging. Such provisions are necessary under a progressive income tax so that an individual with fluctuating income does not bear a heavier tax burden than an individual with the same average income received at a steady rate. Since annual consumption does not fluctuate as much as annual income, there would be less need for complex averaging provisions under a consumed income tax.

Pensions. *A primary administrative advantage of a tax on consumed* income in the area of measurement of individual income lies in the simplification of the tax treatment of pensions. At present, contributions to certain qualified pension accounts are accorded consumption tax treatment; that is, contributions are fully deductible but receipt of both principal and interest is subject to tax. Contributions are, however, subject to limitations, and pre-retirement withdrawals are penalized. However, many pension plans and other vehicles for retirement saving are not covered by these rules. Under a tax on consumed income all saving for retirement -- indeed, all saving -- is accorded uniform treatment: deduction upon contribution and taxation of both the original contribution and subsequent earnings at the time of withdrawal.

2. **Inflation-proof tax base.** *During inflationary periods, the* current income tax generally mismeasures income from capital and from business; real income is understated in some instances and overstated in others. This occurs for a number of reasons: depreciation is based on historical costs; tax is collected on nominal capital gains, rather than real (inflation-adjusted) gains; the deduction for the cost of goods sold from inventory is often based on the value of the oldest goods in stock at the beginning of the year; and interest income and expense are calculated without recognizing that nominal interest rates include an inflation premium that should neither be taxed nor deducted. During the 1970s the mismeasurement of business and capital income resulted in substantial overtaxation of these forms of income, which in addition to being inequitable, had a serious depressing effect on capital investment. Adjusting depreciation allowances, the cost of goods sold from inventories, capital gains, and interest income and expense for inflation is inevitably complicated. Because the tax on consumed income is based on cash flow, it requires no inflation adjustment to make it inflation-proof. Cash flow is inherently measured in dollars of the current period, so there is no occasion to combine current income and expenses with historical ones.

3. **Tax shelters and tax arbitrage.** Tax shelters and tax arbitrage are a major source of inequity and distortion under the current income tax system. Any attempts at reforming the tax system must address their underlying causes; these include -- usually in combination -- acceleration of deductions for expenses, preferential treatment of capital gains or the return to saving (often through vehicles typical of a consumed income tax, such as pensions, IRAs, and life insurance policies with large saving components), and borrowing in order to realize deductions for interest expense. The relative advantage of the consumed income tax with respect to tax shelters is the simplicity of the solution. By addressing the underlying causes of tax avoidance, a well-structured income tax would certainly reduce the use of tax shelters. But it would require extensive and complex provisions, including "at risk rules" intended to prevent taxpayers from taking

deductions in excess of their actual investment in the asset, limitations on the deduction of inflation-adjusted interest expenses, real economic depreciation with more complete cost capitalization rules, and full taxation of real capital gains.

In contrast to the complex rules necessary to prevent tax shelters under an income tax, existing tax shelters would simply disappear with the tax exemption of capital income. The relative advantage of current tax shelters would be eliminated if all purchases of capital goods were expensed, if capital gains and the returns to saving were taxed only when consumed, and if borrowing were subject to tax unless offset by additional investment.

Some caution must be exercised, however, in extolling the relative advantage of a consumed income tax with regard to tax shelters. Unless the family was the tax unit, and to some extent even if it were, attribution of consumption to related individuals subject to low marginal tax rates would be a new tax reduction technique under a graduated consumed income tax. This is just one example of how any tax preference or possible tax loophole would likely be exploited under a consumed income tax. The difficult measurement issues which gave rise to loopholes in the present income tax are fairly well known after 70 years of experience. Similar measurement difficulties in an actual consumed income tax would probably give rise to many new and different "tax shelters".

B. Economic Advantages

Advocates of a consumed income tax argue that it would have two important advantages over an income tax. First, it would not distort the consumer choice between present and future consumption. Second, it would probably increase saving, which in turn would increase investment, productivity and growth. Implementation of a consumed income tax would also affect individual behavior regarding gifts and bequests.

1. **Economic neutrality.** An individual can consume income now or save it in order to consume it later. The cost or "price" of future consumption is inversely related to the net rate of return to saving obtained by the individual; a higher rate of return implies a lower price, since more future consumption can be purchased for any amount saved. A consumed income tax does not change the price of future consumption since it does not change the rate of return to saving. In contrast, by taxing the return to saving, the income tax raises the price of future consumption, thus distorting the choice between consuming now or saving for future consumption. In this sense, unlike the income tax, the consumed income tax does not discriminate against saving.

However, eliminating the income tax discrimination against saving by enacting a consumed income tax would have some adverse effects as well. Although only the income tax discriminates against saving, both the income and consumed income taxes distort the individual decision to work more or take more leisure (broadly defined to include non-market production in the home). However, tax rates must be higher under a consumed income tax, as the base is smaller. As a result, the consumed income tax distorts the work-leisure choice more than the broad-based income tax does. Thus, in terms of overall economic neutrality, the relative merits of the two taxes are unclear on theoretical grounds. (The theoretical argument is unlikely to be resolved in the near future; for example, there is little empirical evidence and no consensus about the value of an esoteric but critical parameter in the analysis -- the labor supply response to changes in the return to saving.) Under many assumptions about individual behavior, the consumed income tax results in a smaller total distortion of the two choices and thus is preferable in terms of economic neutrality. However, under other assumptions, the income tax can be shown to result in a smaller overall distortion.

2. **Effect on saving.** The effect on saving of implementing a consumed income tax is also controversial. As described above, saving would be encouraged under the consumed income tax because the income tax discrimination against saving would be eliminated. However, because the net return to saving would be higher, any particular goal for future consumption could be attained with less current saving; this would reduce the need to save. The net effect of taxation on saving is a topic of much debate. Most economists believe that, relative to an income tax, a consumed income tax would result in more saving, and thus more investment, faster growth and eventually higher wages; some contend the effects would be very significant. However, many economists argue that little change in saving would result.

Also, if the marginal tax rate at the time of dissaving were lower than the tax rate at the time the deductions were taken, the effective tax rate on the return to saving would be negative -- not only would the government collect no tax on the saving, it would actually pay people to save. Although this would further encourage saving, it would reduce total tax collections and require higher marginal tax rates on the remaining tax base.

3. **Effects on gifts and bequests.** The tax treatment of gifts and bequests under the consumed income tax would affect individual decisions to give and to leave inheritances. Gifts and bequests would probably be stimulated if they were taxed only to the recipient. However, the opposite effect would occur if they were taxed to both the donor and recipient. Saving would also be stimulated in the former case but discouraged in the latter.

C. Equity Advantages

Many advocates of taxes on consumed income believe that consumption provides a better measure of ability to pay than does income. One argument for a tax on consumed income is that annual income, which is subject to considerable fluctuation, is a less satisfactory indicator of ability to pay than is permanent income, and that consumption is a better proxy for permanent income than is annual income.

At another level of sophistication, some advocates of a particular form of consumed income tax argue that ability to pay should be measured in terms of lifetime income, rather than annual income. Lifetime income can, in turn, be measured in present value terms in either of two ways: as the sum of gifts and bequests received plus labor income, or as the sum of consumption plus amounts given or bequeathed to others. Under this rationale, the tax base of the tax on consumed income is appropriate because it is exactly a measure of lifetime income, but only if gifts and bequests are included in the tax base of the donor as well as the recipient.

The consumed income tax can be viewed as more equitable than an income tax from the perspective of the lifetime. Under certain circumstances, including a constant tax rate over the lifetime of the taxpayer, the value of taxes paid under a consumed income tax does not depend on when a person consumes or receives earnings. By comparison, an income tax levies higher taxes on individuals who earn income at a relatively early age or spend it at a relatively older age.

Finally, some advocates of a tax on consumed income believe it is more equitable because individuals should be taxed on "what they take out of the pot" (consumption) rather than "what they put into it" (income). Since this position basically involves philosophical judgments, it is inherently inconclusive.

III. Disadvantages of a Consumed Income Tax

Although the advantages of a tax on consumed income are numerous, the Treasury Department believes they are outweighed by a number of serious administrative, economic, and equity disadvantages. These include increased complexity for individual taxpayers, higher marginal tax rates, serious compliance problems, perceived unfairness, and a lengthy transition period with complicated treatment of existing wealth. Again, the relative advantages and disadvantages of a comprehensive consumed income tax must be compared to those of a broad-base income tax, not just to the current income tax system.

A. Administrative Disadvantages

A consumed income tax would be simpler for business and for taxpayers with much capital income. However, it would probably be more complicated for the average individual taxpayer. The elements of a consumed income tax required to separate saving from consumption would be unfamiliar and complex. In addition, increased compliance difficulties, troublesome international issues, and potential constitutional challenges are unique to a consumed income tax.

1. **Complexity for average taxpayers.** Under a consumed income tax, problems of measuring the tax base for individuals would be different,

rather than eliminated. For the family of a typical wage earner, the problems of measuring capital income that a consumption tax avoids are of little concern. Such a family's tax picture would be complicated by the addition to the tax base of borrowing and savings account withdrawals. Also, taxpayers would confront a more elaborate tax administration system, with "qualified accounts" for all financial transactions, and the possibility of withholding on borrowing, on withdrawals of savings, as well as negative withholding on deposits in qualified accounts.

Borrowing. Most families would have to keep track of their net borrowing under a consumed income tax. In addition to reporting their wage income, they would have to report any new borrowing and any repayments of prior borrowing. Taxpayers would find it hard to understand why all borrowing -- including consumer loans, credit card debt, and business loans -- would be part of the tax base. Unlike the present income tax, with its deduction of gross additions to IRAs, a consumed income tax would allow a deduction only for net saving, that is, increases in saving in excess of increases in debt. Conversely, any increases in debt in excess of the increase in saving would be included in the tax base.

Qualified financial accounts. The requirement that almost all financial transactions be conducted through qualified accounts would reduce a taxpayer's financial flexibility and ability to maintain the privacy of his or her financial affairs. Taxpayers would have to learn to think of amounts accumulated in a qualified account as pre-tax funds. The amount of consumption a given amount of saving could buy would be less than the amount accumulated, since taxes would have to be paid on any net withdrawal from an account. The same is true of existing state sales taxes, but not of the current income tax.

Treatment of personal-use assets. The tax treatment of housing, autos, other consumer durables, and "collectibles" like art and antiques is an important and difficult issue under a consumed income tax. These items have both consumption and investment characteristics since they provide consumption services over a number of years. Treating them like ordinary consumer goods by including the full purchase price in the tax base overstates the taxpayer's consumption that year. However, there are no annual monetary payments, like lease payments paid by a renter, associated with these goods to indicate the amount of annual consumption services.

Treating personal assets like ordinary investments, on the other hand, understates the taxpayer's consumption. Owner-occupied housing and pieces of art provide good examples of this. Suppose an individual buys a house or painting for $100,000 and sells it for the same price three years later. If the purchase is treated as an investment, an individual would be able to deduct the purchase price of $100,000 and then include the resale price of $100,000 in taxable income. In this example the taxpayer has no net tax liability (indeed he postpones tax for three years). Yet the house or art has provided consumption benefits while used by the taxpayer. If the purchase price were deductible, the ownership and use of a car that was bought for $10,000 and sold three years later for $4,000 would actually reduce tax liability, thus subsidizing the consumption services provided by the personal asset.

One compromise way to treat personal use assets would require consumers to include the full purchase price of certain major consumer assets in the tax base but allow them to spread out the tax payments over a number of years. But averaging is notoriously complicated anytime there is a change in the taxpaying unit, such as through marriage, death, or divorce. Alternatively, purchases of a limited group of consumer durables, perhaps only housing, could be made out of non-qualified accounts; the proceeds of loans from such accounts would not be included in the tax base, and deposits and repayment of loan principal and interest would not be deductible. Under certain circumstances, this treatment would be equivalent to the qualified account approach in terms of present value of tax liability. However, the simultaneous use of qualified accounts for certain transactions and non-qualified accounts for others increases complexity and the potential for tax avoidance. In addition, this treatment raises questions about the proper treatment of extraordinary gains realized upon disposition of the asset.

Extended withholding. Under the present system of withholding, most taxpayers experience little net tax liability at the end of the year. Relatively few taxpayers are required to file statements of estimated tax and make quarterly payments of tax. Even with itemized deductions, most taxpayers can adjust withholding to achieve a satisfactory degree of similarity between total amounts withheld and ultimate tax liability. Those who file estimated returns generally have substantial non-labor income that is not subject to withholding and are more able to cope with the complexities of filing an estimated return.

The situation is potentially quite different under a tax on consumed income. Withholding applied only to income would frequently produce a poor approximation of ultimate tax liability if the tax base were consumption, rather than income. With withholding on consumed income, most taxpayers would have to become more actively and frequently involved in determining their withholding, guessing and revising their expected consumption several times a year. In the absence of a system of withholding on loans and withdrawals, any major purchase, such as that of a vacation or an automobile, could result in a substantial underpayment of tax. Consumer loans or withdrawals taken out near the end of a year might be particularly troublesome, since they could not easily be reflected in withholding, unless anticipated earlier. For example, loans taken out to finance Christmas presents might unexpectedly increase tax liability for many taxpayers. Year-end contributions to savings accounts may also not be reflected in withholding during the year. But these are likely to be welcome, because they result in reduced tax liability or even a refund, rather than increased tax.

Both taxpayer convenience and protection of revenues might dictate that a system of universal withholding be applied to all loans, withdrawals, deposits, and repayments. This prospect raises several problems. Under a graduated tax schedule, the lender would not know the correct rate at which to withhold, so that withholding would have to be at a flat rate. With a simplified rate structure, this might not appear to be problematic, since most taxpayers would be subject to tax at the same marginal rate. However, it would overwithhold low consumption taxpayers and underwithhold large consumers. In addition, withholding on loans and repayments would logically be coupled with negative withholding on saving: for a $5,000 deposit, the bank would credit $6,000 (at a 20 percent withholding rate). At a minimum, this would be complex and confusing to taxpayers.

2. **Compliance.** With consumption defined as income minus net saving, a tax on consumed income would entail many of the compliance problems of an income tax -- plus additional difficulties of monitoring saving and dissaving. While taxpayers would have an incentive to report all the deductions for saving and investment to which they are entitled, they would have an incentive for not reporting withdrawals or borrowing. Consequently, qualified accounts could only be established in institutions that could provide reliable and accurate reporting.

Tax evasion would be more rewarding and consequently more tempting with a tax on consumed income. In this case, evasion would involve not reporting or erroneously deducting the full principal plus earnings on capital transactions, rather than just the earnings. The IRS estimates that 40 percent of capital gain transactions are not reported. This is serious enough under current law, where only the gains are taxed, and at preferential rates. It would be much more serious under a tax on consumed income, where the entire proceeds of a sale, not just the gain, would be taxable (unless reinvested) and at ordinary rates. Compliance with a consumed income tax would therefore require a more extensive system of information reporting and monitoring than does an income tax.

To prevent legal "gaming of the system" and illegal tax evasion, a number of comprehensive, and possibly complex enforcement procedures would be necessary. These would go beyond third-party information reporting that would be useful under an income tax. They might include a comprehensive inventory of all existing wealth upon enactment of the tax, registration of private borrowing, and a far-reaching system of exchange controls to facilitate policing of foreign transactions.

3. **Constitutionality.** The Sixteenth Amendment of the U.S. Constitution empowers the Federal Government "... to lay and collect taxes on incomes, from whatever source derived ...." Experience suggests that the Sixteenth Amendment would not prevent taxation from being limited to income that is consumed. After all, many forms of saving now effectively result in tax exemption. Nor does there appear to be any problem in taxing dissaving of amounts that have previously

benefitted from tax exemption or deferral, such as qualified pension accounts, individual retirement accounts, or Keogh plans; this is also a feature of current law. But the tax on consumed income goes beyond the deduction for saving, deferral of tax on interest, and inclusion of dissaving in the tax base. It includes borrowing in the tax base, even for taxpayers who have no income. Although a consumed income tax is not likely to be found unconstitutional, there is little doubt that the constitutionality of a tax on consumed income would be challenged on the ground that the Sixteenth Amendment does not allow imposition of a direct tax on amounts borrowed. Such a challenge might impair administration of the tax pending resolution of the dispute in the courts.

4. International issues. A shift by the U.S. to a consumed income tax would at best be disruptive of international relations, would increase the opportunities to use foreign transactions to avoid or evade U.S. taxes, and would provide tax incentives for immigration and emigration.

The U.S. tax in the world economy. Under current law, U.S. citizens, residents, and corporations are taxed on their worldwide income, with credit for foreign income taxes paid. Nonresident aliens and foreign corporations are generally taxed on their U.S. source income. It would be impossible to require all international savings transactions to flow through U.S. qualified accounts. Therefore, a shift to a consumed income tax would apply only to U.S. residents; for them the tax base would be worldwide consumption. A deduction for foreign income taxes paid could be allowed; however, it would be difficult to devise a workable foreign tax credit. For nonresidents (citizens and noncitizens alike), the tax base would continue to be income -- income from U.S. sources (which would be a change for nonresident citizens). The corporate income tax could be eliminated for both domestic and foreign corporations, though retaining it during a transition period would help phase out the foreign tax credit. In order to tax the corporate income of nonresident investors, "withholding-at-source" taxes on their dividends and interest could be raised; taxing their share of earnings retained by U.S. corporations would be more problematical.

Eliminating the corporate income tax and replacing the foreign tax credit with a deduction would increase the attraction of U.S. investment, relative to investments elsewhere, for domestic and some foreign businesses. Other nations might object to the resulting capital outflow. In addition, after the many years that the U.S. has had a foreign tax credit and advocated it as a mechanism for relieving double taxation and achieving "capital export neutrality," other nations might protest the replacement of the credit with a deduction as a breach of a longstanding commitment. In many cases, such a change would require overriding an existing U.S. tax treaty with the other country.

Compliance. Detecting foreign borrowing and receipts from foreign corporations raises compliance problems for a consumed income tax that are more serious than under an income tax. U.S. residents could borrow abroad and then "save" the unreported foreign borrowing in a domestic qualified account, thereby lowering current year taxes by taking a deduction for the "saving". This would not necessarily reduce the present value of their tax liability, since they would not be able to deduct future repayments on the loan. (If such repayments were deductible at lower rates, taxes would be reduced.) It may, however, be viewed as inequitable to allow those taxpayers with access to foreign lenders to juggle the timing, if not the present value, of their tax liability. Futhermore, the proper timing of foreign loans and U.S. deposits would enable the taxpayer to reduce somewhat the present value of the tax liability, as long as there were no withholding on the loan. Allowing deductions for investments in foreign business that the U.S. could not monitor would enable taxpayers to consume the return and repayment of those investments tax free. Solutions could be devised to stop this type of abuse. They would require, however, a great deal of added complexity, either by tracing funds flowing into and out of the U.S., or disallowing deductions for investments in countries with which the U.S. does not have effective exchange of information arrangements.

Emigration and immigration. A pioneering shift by the U.S. to a consumed income tax would also encourage individuals to emigrate to avoid U.S taxes in times of high consumption, such as retirement. Exit taxes and an expansive definition of residence could moderate this tendency, although again at the cost of increased complexity. *Immigrants* would also be required to include in their receipts assets brought into the country to prevent them from sheltering U.S. consumption. These twin issues of immigration and emigration have not weighed heavily in U.S. debates on the consumed income tax, but several European nations have considered them major obstacles.

B. Economic Disadvantages

All tax systems distort some form of economic behavior -- consumption choices, the work-leisure tradeoff, the consumption-saving tradeoff, financing decisions, production decisions, and the decision to comply with or evade taxes. The types of decisions affected depend on the transactions included in the tax base. Both a comprehensive consumed income tax and a broad-base income tax would reduce many of the economic distortions in current law by lowering marginal tax rates and treating all sources and uses of income more consistently.

One of the advantages of a consumed income tax, under certain circumstances, is neutrality with respect to the consumption-saving tradeoff. However, in order to achieve this neutrality while financing a given level of Federal Government services, the exclusion of net savings from the tax base requires higher marginal tax rates on the remaining taxable items. Higher marginal tax rates increase the efficiency losses from the remaining distortions in the tax system.

1. Higher marginal tax rates on wages. As noted above, marginal tax rates on wage income would be higher under a consumed income tax since capital income would effectively be excluded from the tax base. As a result, the consumed income tax would discourage work effort more than would a broad-base income tax applied to both capital and labor income. The work disincentive would fall hardest on second workers. The higher marginal tax rate might encourage more non-market activity or underground economy activity that is not subject to tax, further narrowing the base for a consumed income tax.

2. **Tax preferences under a consumed income tax.** Much of the discussion of consumed income taxes has implicitly been overly optimistic about the possibilities of the repeal of all tax preferences and the complete neutrality toward saving that consumption tax treatment would imply.

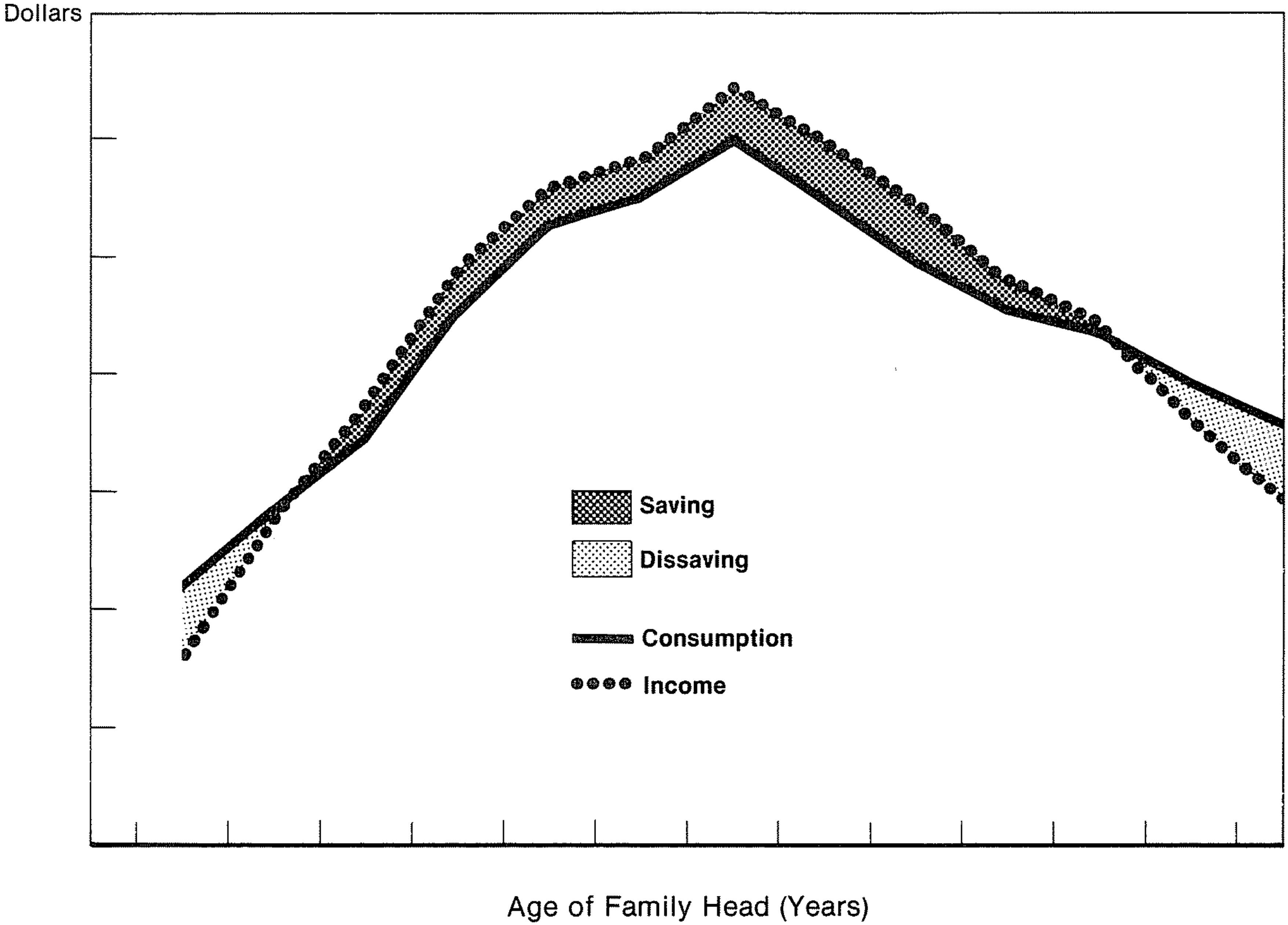
Under a consumed income tax, the effective tax rate applied to income from capital would be zero only if no form of capital income benefitted from preferential tax treatment. But historical experience in the United States suggests that zero would only be an upper bound on the taxation of capital income under a consumption tax.

Under an ideal consumed income tax all interest income would be exempt until consumed. In such a system state and local securities would lose their tax advantage over other investments. If political forces succeeded in maintaining the existing differential between the treatment of interest from state and local bonds and other forms of investment income, it would be necessary to pay a Federal subsidy on interest from such bonds. Similarly, if it were desired to continue preferential tax treatment for housing, energy or other natural resources, research and development, or any of the many other forms of investment that now benefit from preferential treatment, it would be necessary to extend to those activities a negative effective tax rate. To provide any preferential treatment of particular investments through the tax Code, legal tax shelters would have to be permitted, with the resulting economic distortions and perception of unfairness. Negative effective tax rates would perpetuate the type of distorting effect that the present tax system has on the allocation of resources. As under current law, the investment projects that were the most productive for the economy would not necessarily provide the most attractive after-tax yield. This differential would lead resources to flow to less productive uses, preventing the economy from reaching its maximum level of output and growth.

Even if preferential tax treatment is not accorded to particular investments, a consumed income tax with graduated rates and a tax threshold may reduce the effective tax rate on some saving below zero. This is inherent in the typical pattern of lifetime saving and consumption. (See Figure 9-1.) Most saving occurs during middle age (during working and child-raising years) at the same time when family consumption is highest and thus marginal tax rates are highest. Dissaving and borrowing occur during periods when consumption is lower and thus when marginal tax rates are lower. Therefore, the present value of the tax deduction of savings (and repayment of debt) would possibly be greater than the present value of the tax liability on

Figure 9-1

LIFETIME PATTERN OF INCOME AND CONSUMPTION
(Average Income and Consumption, Distributed by Age of Family Head)



borrowing and dissaving for some taxpayers. The tax system would actually subsidize saving, paying people to save at the cost of higher taxes and tax rates on labor income. This problem might be reduced in a system with relatively wide tax brackets.

3. **Corporate taxes under a consumed income tax.** One of the advantages of a consumed income tax is that repeal of the corporate income tax would obviate the need for a complicated scheme of integrating the corporate and individual income tax systems. Because investment income would not be subject to tax until consumed, there is no theoretical justification for a corporate income tax under a consumed income tax. As discussed above, there are other reasons, however, why the corporate income tax might be retained with a consumed income tax. If the corporate income tax were retained, the mechanism by which capital income is exempted from tax would pose significant problems.

Under a consumed income tax, all purchases of capital investments are deducted immediately (expensed). The large upfront deductions of investment would offset income earned, and in many cases would be larger than needed to simply offset all tax liability. Any business that grows fast enough or is less profitable than average would owe no Federal income tax liability. Only firms that grow relatively slowly or have above average profitability would pay corporate tax. This result would cause the fairness of the tax to be questioned.

The tax system is not likely to allow for full benefit of tax deductions via refunds of excess deductions, due to serious perception problems. In order for firms to utilize excess deductions, there would need to be generous carryover rules with payment of interest by the Federal Government on such "losses". Otherwise -- and perhaps even then -- companies would find it attractive to merge with, or acquire other firms to create a new form of tax shelter. This tax incentive can be expected to distort managerial decisions on firm size, ownership, and product mix, as well as increase industrial concentration and reduce competition.

4. **Government as business partner.** The deduction for saving and investment has the effect of making the government a "silent partner" in the investment. With a 20 percent tax rate, a person or corporation would only have to save $4,000 to invest $5,000; the government provides the other $1,000 through lower taxes. Only if the investment is successful will the government get its money back when the investor decides to use the profits to finance consumption. If the investment fails, the government would lose its investment. Having the government as a partner may influence investors' choices of risk. They may be less cautious in risking losses since some of the money at stake is not their own, but they may also be less adventuresome in seeking high returns since they have to share the proceeds with the government.

C. Equity Disadvantages

Any tax system which is based on voluntary compliance must be perceived as fair and equitable. Although theoretical arguments can be made about the fairness of a consumed income tax over the lifetime of taxpayers (always subject to various assumptions), the public perception of fairness is likely to be judged annually at the time of payment of tax, rather than over the individual's entire lifetime.

1. **Perception of lifetime fairness.** Many taxpayers borrow when they are young and establishing families and most draw down accumulated savings (dissave) during retirement. During middle age, people save to retire previous indebtedness and accumulate wealth with which to finance retirement. Under the current tax on annual income, most families pay relatively little tax when they are young and have low incomes and again when they are old and retired and drawing down accumulated wealth; by comparison, they pay relatively more tax during middle age. Under the consumed income tax there would be a shift in tax liability toward periods of borrowing and dissaving and away from periods of saving and repayment of debt. Thus, although similar in present value terms, taxes would be higher during early adulthood and retirement than under the income tax; similarly, during middle age taxes would be lower than under the annual income tax. Though an economic argument can be made that this pattern of tax payments is more neutral and more equitable than that under the income tax, it seems unlikely that this would be the public perception.

2. **Perception of fairness between rich and poor.** There is a general presumption that all taxes on consumption must be regressive, because consumption falls as a percentage of income as income rises. While this presumption is generally accurate for consumption taxes based on transactions, such as a value-added tax or retail sales tax, it need not be accurate for a personal tax on consumed income. A tax on consumed income can be made progressive by allowing personal exemptions, a zero-bracket amount, and graduated rates.

The ultimate judgement on the fairness of the income tax relative to a tax on consumed income comes down to a subjective choice between income and consumption as the more appropriate standard for measuring both economic equals and economic inequality for tax purposes. If the accumulation of wealth has value beyond the consumption that it can buy -- if it confers power, prestige, or peace of mind -- then annual consumption does not measure equals. In that case, a consumed income tax would unavoidably be unfair even if it assessed the same tax on all individuals with the same lifetime income.

A distinction is sometimes made between wealth that individuals accumulate during their lifetimes as a result of their own energies, and wealth that is inherited from previous generations. The treatment of gifts and bequests under a consumed income tax then becomes an important factor in judging the overall fairness of the system.

Indeed some supporters of a consumed income tax consider such a tax equitable only if gifts and bequests are taxed to both the donor and the beneficiary.

D. Transition Problems

One of the most serious obstacles to adoption of a consumed income tax is the treatment of existing wealth. Movement to a tax on consumed income raises special transition issues beyond those that result from any broad-based tax reform. The unique issues involve how consumption out of wealth accumulated under the current income tax ("old wealth") should be treated, and how repayment of debt incurred under the current system ("old debt") should be treated.

There are three possible approaches to these issues, each of which has significant drawbacks.

Taxing old wealth. First, all old wealth could be subject to tax when consumed. With no special transition rules, old wealth would be treated the same as newly accumulated wealth. Taxing old wealth (and deducting repayment of old loans) would broaden the tax base immediately, and thus permit low tax rates, but it would be an inequitable approach to transition and fraught with compliance problems.

All wealth existing on the effective date of the new tax would have to be registered and considered to be in qualified accounts. Taxpayers would have a clear incentive to understate assets. This could be done most easily by converting them to cash or balances held abroad. Such assets could then be fed back into the system as saving or used for tax-free consumption. Though this problem would be temporary, until all hidden assets had been revealed, the revenue loss and inequities it would produce would be enormous. To prevent hoarding of cash, it might be necessary to introduce a new system of money on the effective date of the consumed income tax. To prevent hoarding in foreign accounts, even more far-ranging steps, possibly including foreign exchange controls, would be necessary.

Individuals consuming out of old wealth would generally be taxed twice: Once when they had saved under the income tax out of after-tax dollars, and then again when they consume under the new tax on consumed income. This would be particularly difficult for the elderly because many would have saved without counting on a second tax on their consumed income. Conversely, issuers of old debt would receive a windfall gain. They would deduct interest and repayments of principal, even though the loan was never included in their tax base. Special relief could be provided to older taxpayers, but only by complicating the system considerably. The practical difficulties of wealth inventory at the beginning of the new tax system and the extreme inequities of taxing old wealth and subsidizing old debt make this approach infeasible.

Exempting old wealth. Second, all old wealth could be exempt from the new tax. If all wealth owned on the day the consumed income tax became effective were considered to be in nonqualifed accounts, then these savings would not be subject to tax when used for consumption, and double taxation would not be a problem. This approach, however, would allow wealthy holders of old wealth to eliminate all tax liability for years into the future (perhaps generations) simply by shifting assets from nonqualified accounts to deductible qualified accounts, thereby reducing their tax liability. Separate accounting for old and new wealth would greatly complicate compliance and administration. The reduction in the tax base would necessitate such high marginal tax rates on the remaining tax base that any efficiency gains from a consumed income tax would be postponed for decades.

Partial exclusion of old wealth. A middle ground solution would be essential, in which taxpayers were allowed some minimal amount of tax-free consumption from accumulated wealth. One possible approach to reduce windfall gains and losses would be to allow a limited amount of old wealth accumulated out of after-tax income to buy tax-free consumption, but to allow a deduction only for new saving (not for repayment of debt). Windfall gains and double taxation of existing wealth would be reduced, but not eliminated. Distinguishing between old and new saving would be difficult and would require complex rules, such as those required to determine what portion of the trillions of dollars worth of existing land, housing, stocks, and other forms of wealth was purchased out of after-tax income. Moreover, limitations on tax-exempt consumption would be difficult to monitor and to administer when the taxpaying unit changes. At the very least, such a partial exclusion of consumption would complicate tax compliance and administration for nearly a generation.

IV. Conclusions

The tax on consumed income has considerable attraction. Particularly important is the fact that under the consumed income tax the most vexing problems in the measurement of income from business and capital that plague the current income tax simply do not exist. By comparison, the oft-repeated economic advantages of neutrality toward saving and of equity from a lifetime perspective appear to be secondary.

The disadvantages of a consumed income tax appear to outweigh these advantages. First, the advantages are purchased at the cost of excluding all capital income from tax, a policy that is questionable on equity grounds. Moreover, exempting capital income from tax as a matter of course implies that certain activities can be accorded preferential treatment only by taxing them at negative effective tax rates. The implications of negative tax rates for the misallocation of the nation's capital stock are striking, indeed.

Second, the first nation to implement a tax on consumed income will find itself totally out of step with the international conventions for the taxation of multinational business.

Third, while a consumed income tax would be simpler for business, it would probably not be simpler for most individuals. Withholding would probably be less accurate and more taxpayers would be required to file estimated taxes.

Fourth, the transition to a tax on consumed income raises especially troublesome problems. It would not be satisfactory either to tax all consumption out of previously accumulated wealth or to exempt all such consumption. But any system of partial exemption would cause considerable complexity for a generation of taxpayers. A different type of transition problem involves the possibility of pre-effective date hoarding to avoid paying tax on consumption.

Fifth, advocates of a tax on consumed income do not agree on the proper tax treatment of gifts or bequests. Some would support a consumed income tax only if gifts and bequests were treated as taxable consumption of the donor; others would strenuously oppose taxing these transfers to the transferror. The implications for the pattern of tax burdens on wealthy individuals are quite profound.

All things considered, the Treasury Department has decided against proposing a tax on consumed income and in favor of a modified flat tax on income.